No. 22730

# United States
# COURT OF APPEALS
## for the Ninth Circuit

UNITED STATES OF AMERICA,

*Appellant,*

v.

DOROTHY C. REGAN,

*Appellee.*

## BRIEF FOR THE APPELLEE

*On Appeal from the Judgment of the United States District Court for the District of Oregon*



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### REFERENCES TO RECORD ON APPEAL

In its brief, the appellant has referred to the Record on Appeal containing the original papers filed in the District Court by the symbols I-R. followed by the page number. The appellee has followed this procedure in this brief.

### JURISDICTION

This appeal involves federal income taxes for the years 1960, 1961, and 1962 in the total amount of

$148.70, plus interest (I-R. 21-22). The assessed deficiencies were paid by the taxpayer (I-R. 25). Claims for refund were timely filed on June 7, 1966, with the District Director in Portland, Oregon (I-R. 7-9). Within the time provided by Section 6532 of the Internal Revenue Code of 1954, on November 18, 1966, the taxpayer brought this action in the District Court for recovery of the taxes paid (I-R. 1-9). Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1346(a)(1). The judgment of the District Court was entered on November 6, 1967 (I-R. 21-22). The notice of appeal was filed within sixty days thereafter, on January 4, 1968 (I-R. 28). Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

## STATEMENT OF THE CASE

The statement of the case as presented by the appellant is correct except in the following particular.

In addition to the right to cut merchantable timber on Forest Service Land, Idapine Tenants also had acquired and owned timber in their own right which they sold to Idapine Mills, Inc. (Pl. Ex. 1, p. 1; I-R. 16).

## SUMMARY OF ARGUMENT

Taxpayer was a member of a joint venture known as Idapine Tenants which owned certain timber and timber cutting rights, together with logging equipment and lumber manufacturing and remanufacturing plants and sites. During the years involved said

joint venture sold part of its timber and timber cutting rights to Idapine Mills, Inc. and leased to said corporation its logging equipment and plants. The income of the joint venture on the sale of its timber and timber cutting rights was taxable as capital gains under Section 631(b) of the Internal Revenue Code of 1954, and the rental income was taxable as ordinary income.

In carrying on its business of selling timber and leasing equipment and plants, the joint venture constructed certain access roads on the timber land involved, capitalizing and then amortizing the cost of said roads based upon the quantity of timber sold each year. Said road amortization expense was an ordinary and necessary expense of the joint venture in carrying on its timber sales and rental business, and deductible as such under Section 162 of the Internal Revenue Code of 1954. The District Court in its decision correctly so held. Said decision is supported by all the cases touching upon this issue. Conversely, the contention of the appellant that said road amortization expense is a part of the "adjusted depletion basis" referred to in Section 631(b), thereby reducing the capital gain to the joint venture on the sale of its timber and timber cutting rights, is not supported by either statute, regulation, or case law.

## ARGUMENT

**The road amortization expenses of the joint venture were ordinary and necessary business expenses of said joint venture and deductible as such under section 162 of the Internal Revenue Code of 1954.**

*1. Section 162 of the Internal Revenue Code of 1954 allows as a deduction all the ordinary and necessary expenses paid or incurred in carrying on a trade or business.*

*2. Road amortization expenses are not a part of the "adjusted depletion basis" referred to in Section 631(b) of the Internal Revenue Code of 1954, relating to the computation of the capital gain or loss on the sale of timber or timber cutting rights.*

Under Section 162 of the Internal Revenue Code of 1954, Appendix, *infra*, a trade or business is entitled to deduct all ordinary and necessary expenses paid or incurred in carrying on a trade or business. The Treasury Regulation pertaining to said section, Regulation 1.162-1, amplifies said section by stating in part as follows:

> "(a) *In General*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or credit under provisions of law other than Section 162. The cost of goods purchased for resale, with proper adjustment for opening and

closing inventories, is deducted from gross sales in computing gross income. . . ."

Since the joint venture was in the business of selling timber and renting equipment and manufacturing plants, (Pl. Ex. 1, 2 & 3), the taxpayer, as a member of said joint venture, was entitled to deduct from her gross income therefrom all of her share of the expenses relating to said business so long as they were ordinary and necessary, unless they are a part of the "cost of goods purchased for resale." Appellant does not contend that the road amortization expenses of the joint venture were not ordinary and necessary, but asserts that they are a part of the *cost* of the timber and timber cutting rights sold by the joint venture.

The case of *Converse* v. *Earl*, 43 A.F.T.R. 1308 (D.C. Ore., 1951) is directly on point. This case involved payments by the taxpayer for the construction of a logging road on state owned land adjacent to the timber sold by the taxpayer. The Internal Revenue Service, in that case, also contended that the payments for the construction of the logging road constituted capital expenditures and therefore were not deductible as ordinary and necessary business expenses of the taxpayer. The District Court for Oregon held that said logging road expenses of the taxpayer were deductible as ordinary and necessary business expenses.

In a similar case decided by the United States District Court for the District of Oregon, *Watts* v.

*Erickson*, 10 A.F.T.R. 2d 5832 (1962), the court held that fees paid by the taxpayer for the use of timber roads "constituted ordinary and necessary business expenses" to the taxpayer in the year said expenses were incurred. In that case, the taxpayers were members of a partnership which purchased timber from the U. S. Forest Service, and pursuant to said purchase the partnership also agreed to pay certain logging road use fees. The government contended that said road use fees were not ordinary and necessary business expenses of the taxpayer. Said road use fees are equivalent to the road amortization expenses in this case; they both relate to logging road expenses incurred by a taxpayer in the business of acquiring and selling timber. Certainly, if the road use fees in the *Watts* case were deductible as ordinary and necessary business expenses of the taxpayer, then the road amortization expense of the joint venture in the instant case before the court should also be so deductible.

Appellant's position in this case is that since the logging road expenses were incurred by the joint venture to produce capital gains, said expenses must be used in the computation of those capital gains and not taken as regular business expenses (App. Br. 6, 14). To support this argument, appellant contends that the logging road costs are a part of the "adjusted depletion basis" (adjusted cost basis) referred to in Section 631(b) (App. Br. 6, 14).

"Adjusted depletion basis" or "basis for cost de-

pletion" is defined by Section 612 of the Internal Revenue Code as follows:

> "Except as otherwise provided in this subchapter, the basis on which depletion is to be allowed in respect of any property shall be the adjusted basis provided in Section 1011 for the purpose of determining the gain upon the sale or other disposition of such property."

Section 1011 of the Internal Revenue Code, Appendix, *infra,* states that reference must be made to Section 1012 for the purpose of computing basis for determining the gain or loss from the sale or other disposition of property. Said Section 1012 reads in part as follows:

> "The basis of property shall be the cost of such property, except as otherwise provided in this subchapter. . . ." (26 U.S.C. 1964 ed., § 1012).

Further light is shed upon the definition of the basis of timber for depletion by Regulation 1.612-1(b) (1) which reads in part as follows:

> "(1) The basis for cost depletion of mineral or timber property does not include:
>
> (i) Amounts recoverable through depreciation deductions, through deferred expenses, and through deductions other than depletion, and
>
> (ii) The residual value of land and improvements at the end of operations. . . ."

The last regulation quoted above clearly indicates that road amortization expenses are not to be includ-

ed in the basis of timber for purpose of depletion, and therefore are not included in the adjusted basis of said timber for determining gain or loss under Section 631(b) of the Internal Revenue Code.

Although not specifically involving road amortization expenses, the case of *Drey* v. *U. S.*, 7 A.F.T.R. 2d 333 (D.C., E. Dis. of Mo., 1960) is very much in point. The government contended in that case that certain expenses of the taxpayer, (cruising of timber areas by employees, marking out the sections ready for cutting, and inspection of cutting to prevent purchasers from getting over lines) constituted direct sales expenses to be used in computing the capital gain to the taxpayer on account of the timber sold. The court in its opinion likened the sale of timber to the sale of any other item of inventory, and stated that it is only by special statute that the sale of timber is treated the same as the sale of a capital asset. Since the taxpayer was in the business of selling timber, all expenses incurred by him arising out of the ordinary course of said business were deductible as ordinary and necessary business expenses and were not to be considered as part of the capital gain computation. As stated by the court:

> "In the case at bar it is the Court's conclusion that the question here presented is whether or not the expenses of the plaintiff arose and occurred in the ordinary course of his business as contemplated in 26 U.S.C., Sec. 162. . . . Here Plaintiff's expenses arose in the ordinary course of his business. The fact that these expenses are

> attributable to the production of income taxable at the capital gain rate does not place them without the ordinary and necessary business expense category. . . ." (p. 337).

The court in the *Drey* case cited with approval the case of *Alabama Land Co.* v. *Commissioner*, 28 B.T.A. 586, in which case the court held that expenditures for cruising timber were deductible as ordinary and necessary business expenses even though said cruises related to the later sale of said timber. Thus, if cruising timber for purpose of sale is so deductible, no logical reason can be seen why road amortization expenses should not also be deducted as ordinary and necessary business expenses.

The same argument as appellant is making in this case was presented to the Court of Claims in *Union Bag-Camp Paper Corporation* v. *U. S.*, 325 F.2d 730, 12 A.F.T.R. 2d 6127 (1962). In that case, the taxpayer was in the business of selling timber under cutting contracts with others. The taxpayer deducted on its tax return, as ordinary and necessary business expenses, its total land management expenses which consisted of salaries, depreciation, supplies, repairs, travel, entertainment and insurance. The government contended that part of these expenses should be allocated to the sales of timber and thereby reduce the gain realized from such sales. In rejecting the government's contention, the court reviewed the history of the tax law in this area and found that nowhere in the statutes enacted by Congress did Congress ever

restrict the capital gain relief provision relating to timber sales, "although in its deliberation with the 1954 Code, Congress had considered and rejected proposed legislation prohibiting the deduction of the types of expenditures here at issue . . .". The court concluded its opinion with the following remark which is equally pertinent to the issue now before this court:

> ". . . Absent specific language in the statute or regulations so requiring, it should not be held that the taxing authority has with one hand granted a special tax benefit to a natural resource industry, but with the other hand has taken back part of the benefit through the medium of disallowing a deduction to which the taxpayer had previously been entitled." (p. 744)

The case of *Spangler* v. *Commissioner*, 323 F.2d 913, 12 A.F.T.R.2d 5831, C.A. 9, 1963) and the other cases cited by appellant on page 15 of its brief are not in point. Said cases involved expenses relating to the sale of *capital assets*. However, the deduction of appraisal costs, legal fees, litigation costs and commissions in the sale of *capital assets* (the factual situation in those cases) cannot be likened to the sale of timber, a *non*-capital asset. Appellant in effect contends that all expenses of a timber operator or dealer should be treated no differently than the expenses relating to the sale of capital assets. This same contention was flatly rejected in the case of *Drey* v. *U.S.*, *supra*, wherein the court stated:

> ". . . We cannot glibly equate the disposition of timber with the sale of a capital asset. 26

> U.S.C., Sec. 1221, in defining 'capital asset' states that that term does not include '(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer * * * or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;'. A reading of all of the statutes involved leads this Court to the conclusion that timber would not be afforded capital gain treatment except that it is authorized to be treated as such under the theory of a depletion allowance. Therefore, we are not actually dealing with the sale of a capital asset but dealing with the sale of a commodity which is afforded capital gain treatment by statute." (p. 337)

The appellant asserted this same argument in *Union Bag-Camp Paper Corporation* v. *U. S.*, *supra*. In discussing the tax benefits given to the seller of timber by the Internal Revenue Code, the Court stated:

> ". . . These statutory provisions, designed by Congress 'to afford relief to timber owners,' (Boeing v. United States, supra, at page 584 of 98 F. Supp. at p. 25 of 121 Ct. Cl.) contain nothing which on any normal reading would prohibit the deduction by a timber dealer from income of his ordinary and necessary expenses incurred in the growing or selling of his timber, or which would require him to offset such expenses against capital gains realized on timber sale or disposals." (p. 743)

Appellant's resort to Rev. Rul. 58-266, 1958-1 Cum. Bull. 520 is of no avail. Although using the

phrase "coal or timber" in said ruling, the factual situation giving rise to the ruling involved a taxpayer who was in the business of selling *coal*, not timber. As restricted to coal, said ruling is supported by Section 272 of the Code enacted in 1954. The court in the *Union Bag* case, *supra*, pointed out that when Section 272 was being considered by Congress in 1954, said section originally referred to both coal and timber, but "the Senate Finance Committee eliminated this provision with respect to timber, and the Senate's action was accepted by the Conference Committee. S. Rept. No. 1622, 83d Cong., 2d Sess., p. 229 (1954); H. Rept. No. 2543, 83d Cong., 2d Sess. p. 33 (1954)." The Court then proceeded to point out that as applied to timber Rev. Rul. 58-266 is not supported by statute or long standing regulation:

> "A fortiori, in the area of the present dispute, no longstanding regulation, or even a fluctuating one, has prohibited the deductions sought. Instead, with respect to the question here involved, the applicable regulations have been entirely silent and have merely repeated the language of the parent statute, Section 117 (k)(2). See Treas. Reg. 111, sec. 29.117-8(b) and Treas. Reg. 118, sec. 39-117(k)(1)(b). It was not until 1958, when Rev. Rul. 58-266, supra, was issued that administration action in this field was taken. Meanwhile, as pointed out above, in its deliberations on the 1954 Code, Congress had considered and rejected proposed legislation prohibiting the deduction of the type of expenditures here at issue. From the foregoing, it is clear that plaintiff should not be required to offset against cutting

contract proceeds any part of its forest management expense *even if it be assumed that, as a practical matter, some portion thereof could be singled out as selling expense. . . .*" (p. 743) (emphasis added)

In a later case involving the same taxpayer, *Union Bag-Camp Paper Corp.* v. *U. S.*, 366 F.2d 1011, 18 A.F.T.R.2d 5758, (Ct. Cl. 1966), the Court followed the principles laid down in the prior case and *rejected* the government's contention that 1) annual payments by the taxpayer for use of timber lands and 2) portions of its management expense must be included in the acquisition cost of the timber involved or allocable to the cost of the timber sold. It should be noted that in footnote 6 of the opinion, reference was made to the fact that the taxpayer was entitled to build and maintain roads on the land involved.

In accord is the recent case of *Ransburg* v. *U. S.*, 281 F. Supp. 324, 21 A.F.T.R.2d 560 (D.C. Ind., 1967), involving expenses for pruning and shearing Christmas trees, the sales of which are entitled to capital gains treatment the same as timber under Section 631. After reviewing in detail the legislative history relating to the special tax benefits granted by Congress to timber owners, the court held that said expenses were deductible as ordinary and necessary business expenses under Section 162. As stated by the court:

"Prior to the year 1944, a taxpayer engaged in the business of raising and selling timber was required to report the proceeds of timber sales

as ordinary income and was entitled to deduct all ordinary and necessary expense attributable to such sales under Title 26 U.S.C.A. Section 23(a) (1939 Internal Revenue Code). The Revenue Act of 1943 (58 Stat. 46) amended the 1939 Internal Revenue Code by adding Sections 117(k)(1) and (2). Title 26 U.S.C.A. Section 117(k)(1) and (2) (1939 Internal Revenue Code.) Thereafter, such taxpayer could elect to proceed as he did before the amendment with respect to reporting sales as ordinary income, or to utilize the amendment by reporting the sales as capital gains. The amendment was made to relieve timber owners and there was no express prohibition of the deduction by a taxpayer from income of his ordinary and necessary expenses incurred in growing or selling of his timber, or express provision which would require him to offset such expenses against capital gains realized on timber sales." (p. 326)

## CONCLUSION

No statute, long standing regulation of the Internal Revenue Service or case law can be found supporting the appellant's contention that logging road expenses can not be deducted as an ordinary and necessary business expense. On the contrary, in all the cases that have either directly or indirectly touched upon this subject, the courts have consistently held that logging road expenses or like expenses are properly so deductible. The District Court correctly so held.

Therefore, the judgment of the District Court should be affirmed.

Respectfully submitted,

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Attorneys for Appellee

## CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: 9th day of August, 1968.

EUGENE E. FELTZ
Attorney for Appellee.

## APPENDIX

Internal Revenue Code of 1954:

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—
* * *

* * * * *

(26 U.S.C. 1964 ed., Sec. 162)

SEC. 272. DISPOSAL OF COAL OR DOMESTIC IRON ORE.

Where the disposal of coal or iron ore is covered by section 631, no deduction shall be allowed for expenditures attributable to the making and administering of the contract under which such disposition occurs and to the preservation of the economic interest retained under such contract, except that if in any taxable year such expenditures plus the adjusted depletion basis of the coal or iron ore disposed of in such taxable year exceed the amount realized under such contract, such excess, to the extent not availed of as a reduction of gain under section 1231, shall be a loss deductible under section 165(a). This section shall not apply to any taxable year during which there is no income under the contract.

* * * * *

(26 U.S.C. 1964 ed., Sec. 272.)

SEC. 631. GAIN OR LOSS IN THE CASE OF TIMBER OR COAL.

(a) Disposal of Timber With a Retained Eco-

nomic Interest.—In the case of the disposal of timber held for more than 6 months before any such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such timber, the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber. * * * For purposes of this subsection, the term "owner" means any person who owns an interest in such timber, including a sublessor and a holder of a contract to cut timber.

* * * * *

(26 U.S.C. 1964 ed., Sec. 631.)

SEC. 1011. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

The adjusted basis for determining gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016.

* * * * *

(26 U.S.C. 1964 ed., Sec. 1011).